

OFFICE OF FINANCIAL INSTITUTIONS

OFI BULLETIN

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TO: THE CREDIT UNION'S MANAGING OFFICER OR CEO

SUBJECT: RISKS OF OVERDRAFT PROTECTION PROGRAMS

There is a new spin to an old service that credit unions are considering offering to their members -- overdraft protection programs or what is sometimes referred to as "bounce protection." There are numerous federal regulations to comply with and supervisory issues regarding these programs, including the following:

Compliance Issues

- **Truth in Savings/Part 707 of the NCUA Rules and Regulations** -- proper notification of a significant change in a share account as defined in the regulation. Certain fees must be disclosed in connection with a share account. At the time an account is opened, the disclosures must include the amount of any fee that may be imposed in connection with the account (or an explanation of how the fee will be determined) and the conditions under which the fee may be imposed. (See Part 707.4(b)(4).)

If bounce protection is added to an existing share account, advance notice to the member may be required. A credit union must give advance notice (at least 30 days before the change) to affected members of any change in a term that was required to be disclosed under Part 707.4(b)(4) (which includes fees imposed in connection with the account) if the change may reduce the annual percentage yield or adversely affect the member. (See Part 707.5(a)(1).)

- **Electronic Fund Transfer Act/Regulation E** -- proper documentation is required when preauthorized transfers from a share draft account at another credit union are used to repay an overdraft. A participating credit union would

need to comply with the Regulation E requirements for any preauthorized transfers from member share draft accounts. (See 12 C.F.R. § 205.10(b).)

- **Equal Credit Opportunity Act/Regulation B** -- consistent standards for determining whether a member is eligible or ineligible for a program. An “overdraft” would be “credit” under Regulation B. (See 12 C.F.R. § 202.2(e).)

When a decision is left to the discretion of credit union personnel regarding the offering of bounce protection to an individual member, there may be a potential for disparate treatment in violation of ECOA and Regulation B. Therefore, the credit union’s overdraft protection program must have specific standards for member eligibility in the program to preclude any potential violations of Regulation B. (See 12 C.F.R. § 202.4.)

- **Federal Trade Commission Act** -- regulations to prevent deceptive acts or practices that will mislead a reasonable member. The Federal Trade Commission Act prohibits deceptive acts or practices, including representations or omissions that are likely to mislead reasonable members and, thus, affect a member’s choice or conduct regarding a product. (See 15 U.S.C. § 45(a)(1) and the FTC Policy Statement on Deception dated October 14, 1983). Credit unions must ensure that their marketing materials clearly explain all aspects of the program and do not contain any ambiguities about or overstate the benefits of the program.
- **Truth-In-Lending/Regulation Z** -- regulations to ensure full and fair loan disclosures. Credit unions should note that any violation of this section would also be a violation of LSA-R.S. 6:656(D).

An overdraft would be “credit,” as defined by the Truth in Lending Act and Regulation Z. (See 15 U.S.C. § 1602(e).) The key issue under Regulation Z, however, is whether the fee charged in connection with the overdraft is a “finance charge.” One of the following factors must be present for an overdraft charge to be considered a finance charge: (1) the charge must be previously agreed upon in writing--generally in the form of a loan document. A written share agreement in which the member agrees to a charge when the account becomes overdrawn does not appear to satisfy this requirement. (2) The credit union must agree in writing to automatically pay items that would cause the share account to be overdrawn. (See 12 C.F.R. §§ 226.4(b)(2) and (c)(3).) Again, in our review of Regulation Z, if neither of these factors is present, the

charges are not subject to the limits and restrictions of Regulation Z or LSA-R.S. 6:656(D).

If the fee were determined to be a finance charge, the credit union would have to make the disclosures required in Regulation Z for open-end credit. (See 12 C.F.R. §§ 226.5 and 226.6.)

[NOTE: Presently, the Federal Reserve is reviewing comments they requested on how overdraft protection programs are designed and operated and how these services should be treated for purposes of the Truth-in-Lending Act. Depending on the Federal Reserve's final guidance issued on this topic, the above interpretation of Regulation Z may change.]

- **Loans or Extensions of Credit to Credit Union Officials** -- Overdrafts are considered extensions of credit for purposes of LSA-R.S. 6:656(A)(1)(d) and NCUA Rules and Regulations, § 701.21(d). If a credit union also makes this product available to credit union officials, it must comply with the requirements contained therein.

Supervisory Issues

While it is possible for a credit union to administer this program in a manner that is in full compliance with all of the federal (and state) regulations, there is a significant amount of reputational risk associated with a program that is not administered in a manner that members perceive as being fair. Here are a few examples of the nature of **complaints** our office has received against various financial institutions regarding overdraft protection plans.

- A customer received no prior notice that he was enrolled in this new overdraft protection plan until he noticed an overdraft fee of \$25 plus an additional \$5 charge for every day that his account remained overdrawn. When asked to have the service removed from his account, the institution required that the customer put the request in writing.
- A customer withdraws cash from his account using an ATM. Before the cash was dispensed, a screen was posted on the ATM that stated something like "Account balance = \$100. Available balance = \$150. Are you sure you want to continue with the transaction?" Not realizing the difference between account balance and available balance, the customer chose to withdraw \$150. Three weeks later, the customer received his statement and noticed an overdraft charge of \$25 plus a

daily charge of \$5 for 15 days that the account remained overdrawn for a total of \$100 in service charges.

- This service is often attached to accounts that institutions call “totally free checking accounts.” In some cases, customers would not qualify for an unsecured line of credit but are given “overdraft protection.” Even though very small overdraft limits may be put on these customers, the practice may be considered “predatory lending” if the customers being targeted for this service are not otherwise entitled to such a “privilege.”

Even though the examples listed above may not describe violations of any federal or state law, one disgruntled member could publicize his/her negative opinion of the practice in a disparaging light; and it may be difficult to justify the program in a “court of public opinion.” You may avoid any significant **reputational risks** by initiating the following **practices** with regard to overdraft protection programs:

- Describe the benefits of the plan and allow the member the opportunity to refuse the service before automatically being enrolled in the program.
- Reserve this service for members who would otherwise qualify for a small unsecured loan or those for which the credit union would normally pay their reasonable overdrafts.
- When an account goes into an overdraft status, notify the member that the overdraft protection program has been invoked.
- Perform some type of evaluation on each member enrolling in the plan and set a reasonable limit on the amount and frequency of the overdrafts to be allowed. Properly notify the member of his/her limits.
- Give proper notification to the member if he/she has reached his/her limit or for another reason will no longer be allowed to participate in the plan. Even though documents describing these programs clearly state that the credit union may withhold this privilege and not pay an overdraft at any time, the member may expect the privilege.
- Add explanations to ATM screens that clearly state the difference between an actual and available balance and the additional costs associated with the withdrawal of the available balance.
- Maintain a file of all complaints received on the program and be responsive to valid complaints.

- Consistently apply the program rules to all qualified members who are offered the service.

Before a credit union offers an overdraft protection program, the Board should be fully aware of the **reputation, credit, and liquidity risks** involved and should consider the following:

- Carefully establish the rules for the program to ensure that they are fair and do not target specific demographics.
- The loan policy should address underwriting guidelines, including evaluation of repayment capacity to determine limits, appropriate collection and charge-off procedures, allowance for loan and lease loss guidelines, and guidelines for informative Board and management reports for monitoring purposes.

Credit unions should ensure that overdrafts are not paid for members who do not qualify for loans under prudent underwriting standards that the credit union should be using for all of its extensions of credit. Otherwise, this could increase a credit union's credit risk profile (e.g., higher delinquency and loss rates) by extending credit to borrowers that may not have normally qualified for payment of overdrafts or overdraft protection.

- Ensure compliance with all state and federal laws.
- Consider reputation risk associated with members who may be dissatisfied with the way in which the program is administered.
- Credit unions must have appropriate measuring, monitoring, and reporting procedures established.

Credit unions also need to take great care in entering into contracts with third party vendors. This raises a variety of supervisory concerns that credit unions should address before entering into an arrangement with a vendor in connection with the potential purchase of products including:

- Credit unions should determine whether or not they have the necessary software already in place that is capable of maintaining such a program without incurring the high up-front and ongoing costs associated with using outside vendors.

- Credit unions are expected to conduct due diligence reviews of vendors. This includes initial and ongoing reviews of the financial information of any vendor. These reviews are necessary to ensure that the company can fulfill the representations as outlined in the contract. Requirements for the timing and quality of financial information should be set forth in the contract.
- Credit unions should avoid termination clauses that prohibit or severely restrict the contracting credit union's ability to terminate once the program is initiated. A one-sided termination clause is potentially detrimental for the credit union from a reputation, financial, and strategic risk perspective.

The examination focus will be to assess the risks a credit union has accepted by offering an overdraft protection program to its members, as well as compliance with applicable statutes. In order to do so, examiners will review any documents describing the program, the manner in which the program is administered, any complaints received, disposition of such complaints, and the extent to which the credit union has prepared for the risk by incorporating applicable provisions into the credit union's credit and liquidity/funds management policies. Deficiencies will be summarized in the Report of Examination and reflected in the appropriate CAMEL component(s). If you have any questions, please call your assigned Review Examiner or Deputy Chief Examiner Joe Gardner at (225) 925-4660.

This bulletin will also be posted on OFI's website at www.ofi.state.la.us.

Sincerely,

Sidney E. Seymour
Chief Examiner